

1-1-2001

The Insurer's Reservation of Rights Letter and the Duty To Defend

Greg Munro

University of Montana School of Law, greg.munro@umontana.edu

Follow this and additional works at: http://scholarship.law.umt.edu/faculty_barjournals

 Part of the [Insurance Law Commons](#)

Recommended Citation

Greg Munro, *The Insurer's Reservation of Rights Letter and the Duty To Defend* Tr. Trends 23 (2001),
Available at: http://scholarship.law.umt.edu/faculty_barjournals/22

This Article is brought to you for free and open access by the Faculty Publications at The Scholarly Forum @ Montana Law. It has been accepted for inclusion in Faculty Journal Articles & Other Writings by an authorized administrator of The Scholarly Forum @ Montana Law.

INSURANCE CONSUMER COUNSEL'S COLUMN

THE INSURER'S RESERVATION OF RIGHTS LETTER AND THE DUTY TO DEFEND

BY PROFESSOR GREG MUNRO

Illustrating the insurer's dilemma

The earliest mention of "reservation of rights" in Montana appears in a case initiated by Roland "Laddy" Colgrove of Miles City, one of the founding fathers of the MTLA. He represented a woman named Irion who was badly injured in 1964 in eastern Montana in a collision with a 1957 Mercury driven by a young man named Washington. Laddy discovered that the title to the Washington car had never been properly transferred from the car dealer or the body shop that resold the car to Washington's brother. Ironically, the same insurer, Glens Falls Insurance Company, insured the dealer and body shop under separate garage liability policies and Washington's parents' cars under a Family Auto Policy. Consequently, at the time of the accident, Laddy contended that Glens Falls Insurance Company had the obligation to defend and indemnify under all three liability policies.

Laddy filed suit against Washington, but Glens Falls refused to defend or indemnify Washington under any policy contending that the car was not "owned" by the dealer or body shop so as to be insured under the garage policies, and was subject to the household exclusion under the Family Auto Policy. Instead, the company filed a federal declaratory action in Billings and sought unsuccessfully to have the federal court enjoin prosecution of Laddy's state court action pending decision of the coverage issues. Next, the insurer asked the Montana Supreme Court to enjoin the state court action, again unsuccessfully. Finally, on the morning the case was set for trial, counsel for Glens Falls appeared and took over

the defense of young Washington after making "an oral unilateral reservation of rights"¹ meaning it would defend but did not intend to pay any loss.

One might question whether simply appearing for trial fulfilled the promise to defend, especially because the trial resulted in a judgment in favor of Helen Irion for \$140,000, a large verdict in 1965. The Montana Supreme Court, in *Irion v. Glens Falls Ins. Co.*,² later determined that Glens Falls owed coverage to Washington under all three policies,³ a situation that would surely provoke an attempt at a bad faith recovery today. However, nothing we would recognize as bad faith insurance law existed in Montana in 1965, and it is believed that reservation of rights letters had their origin in the landmark California case of *Gray v. Zurich*⁴ in 1966. Unfortunately, the recorded decisions do not reflect whether Glens Falls suffered any bad faith consequences for its conduct in the Irion case, and Justice Sheehy, an excellent historian who was an attorney tangentially involved in the case for another insurer, could not recall the ultimate outcome.

Failure to defend as bad faith today

It is tempting to conclude that such conduct would surely be bad faith today. After all, in 1982, in *Lipinski v. Title Ins. Co.*,⁵ the court held that the insurer's refusal to defend could be the basis of a bad faith claim for punitive damages independent of the insurance contract. In *Lipinski*, the title insurance company did not discover and disclose irrigation easements to its insured who was subsequently sued for physically impairing those ease-

ments on his land. The insurer, under reservation of rights, defended and settled the first action brought against its insured but refused all defense on the second and was ultimately held in bad faith. Nevertheless, given the state of the law in Montana today, bad faith liability for conduct like that of Glens Falls in the Irion case might not be so clear. If the question framed is whether a carrier's prompt, but incorrect refusal to defend and indemnify is bad faith, then the first inquiry must be whether such conduct is forbidden by Montana's Unfair Claims Settlement Practices Act, MCA §33-18-201. There is no subsection in the act forbidding failure to defend, unless the court reads it into subsection (5) which requires that the carrier "affirm or deny coverage of claims within a reasonable time." While MCA §33-18-242 says that the "insured may not bring an action for bad faith in connection with the handling of an insurance claim," this language has been interpreted by the Montana Supreme Court not to apply to coverage disputes between the insurer and the insured.⁶ If MCA §33-18-201(5) can be read to include failure to defend, then a claim under MCA §33-18-242(6)(a) can be maintained. In that case, the statute allows for punitive damages. The bad news is it also provides the insurer an affirmative defense if it had a "reasonable basis in law or in fact for contesting the claim" under 33-18-242(5).

If failure to defend does not fit within the meaning of MCA §33-18-201(5), then it could form the basis of a common law bad faith claim. The rationale in *Thomas v. Northwestern Nat'l* would provide a basis for such a cause of action. If

a failure to defend claim is held not to fit within the meaning of MCA §33-18-201(5), then it would fall within the ambit of MCA §33-18-242(6)(a), as that section was interpreted by the Supreme Court in *Thomas*. Suffice it to say that today, the litigation over bad faith issues in the *Irion* case would dwarf the personal injury action.

The reservation of rights letter

When consumers of casualty insurance make a claim for defense and indemnification coverage under their policies, they often receive from the insurer a "reservation of rights" letter reserving the right not to indemnify particular claims for lack of coverage or because they are excluded. Sometimes the letters recite a litany of possible reasons the insurer may later choose to deny coverage. Always the letters produce anxiety in the insured consumer who purchased the policy to protect against liability for loss to others

and from having to pay the defense costs involved in a claim against them or their business.

The injured plaintiff likely also has a keen interest in any reservation of rights, since indemnity payment under the tortfeasor's casualty insurance is most often the plaintiff's only realistic source of recovery. The plaintiff's lawyer representing the injured victim in initiating the claim may often be privy to information about a coverage dispute, either through discovery from the defendant or through cooperation with defendant's personal counsel. Plaintiff's counsel should realize that appearance of a reservation of rights letter may mean the injured client will not receive adequate compensation through settlement or satisfaction of the verdict with an insurer's check, but may have to settle for an assignment of the defendant insured's potential rights against its insurer in bad faith tort for the insurer's refusal to provide coverage, defense, or both.

The fact is that the unilateral reservation of rights letter and its counterpart, the "non-waiver" agreement between insured and insurer, both may play an important role in negotiations. The insurer, armed with either one, may wield an effective bargaining chip that may reduce the value of the claim given the possibility that, if the insurer is right, there may be no insurance coverage in the end.

Courts have developed a substantial body of law around these reservation of rights letters and their import on the duty to defend and indemnify. In this issue, I will examine some of that law insofar as it creates rights in the insured and obligations for the insurer. However, I will save the insurer's duty to settle for a future issue, noting only that Gary Zadick concludes that a carrier defending under reservation of rights may not ask its insured for contribution to a settlement unless it has contributed the limits of its coverage.

Structured Settlements

- Personal Injury
- Workers Compensation
- Environmental Cleanup
- Policy Buy Outs

Personal & Confidential Service

Montana Owned • Call Les Marsh

RMAC INC.

Risk Management & Asset Conservation, Inc.

1-800-883-4395

#23 5th Street North
Box 1792 • Great Falls, MT 59403
406-761-4957 • Fax 406-454-9914

Function of the reservation of rights letter

The insured and the insurer may disagree on whether the policy provides defense and indemnity for some or all of the claims reported. The insurer has a duty to inform the insured of its position regarding coverage and defense. The basis of this duty is the insured's interest in making informed decisions to protect itself from the underlying claim.⁷ It is an essential principle of law that, if an insurer elects to defend its policyholder without reserving its right to assert policy defenses to its obligation to pay, it may be later precluded from doing so.⁸ Hence, the reservation of rights letter has become the formal way an insurer undertakes defense while reserving the right to assert that the claim falls outside coverage either because it is not covered by the basic insuring agreement or is subject to an exclusion.

There is a distinction between a reservation of rights letter and the "non-waiver agreement." The reservation of rights letter is a unilateral statement of the insurer. The purposes of the reservation of rights letter are to protect the insurer from claims that it has waived policy defenses or is estopped from asserting them and to give notice to the insured of potential coverage problems. The non-waiver agreement, on the other hand, is an agreement between the insured and insurer in which the insurer reserves its policy defenses and the insured attempts to secure defense.

Standards for the reservation of rights letter

There exists a standard of care that insurers should meet in issuing reservation of rights letters. Some recommendations are for protection of the insurer, while others protect the insured. For example, Clinton E. Miller, a board certified forensic examiner and

national insurance litigation consultant,⁹ sets forth the following standards that should be of interest to the insured:

- After the insurer has completed a prompt, thorough, and objective coverage evaluation, the reservation of rights letter must openly and honestly disclose to the insured all possible policy defenses the insurer knows it may potentially raise.
- The information given to the insured in the reservation of rights letter should include, at least, the following:
 - * date of loss
 - * policy number
 - * claim number
 - * specific policy provisions involved in the coverage dispute, whether they are an exclusion, condition, or definition
- Any coverage question must be clearly defined.
- The insured must be informed of rights to retain personal counsel in view of the conflict that exists between the insured and the insurer.

Miller believes the reservation of rights letter must conform to three elemental requirements:

- 1 It must be communicated to the insured in writing, certified mail, return receipt requested.
- 2 It must be timely, meaning as soon as policy defenses are recognized in the course of a prompt, thorough, and objective investigation.
- 3 It must adequately and fairly inform the insured of the nature of the coverage dispute and the insurer's position.¹⁰

Robert Kelly agrees and says the insurer should explain in the letter why the provision, when applied to the facts, may result in denial of coverage.¹¹ He recommends

that the letter "quote the relevant policy language that is to be the basis for a potential denial of policy benefits in the future." Also, he believes the letter should acknowledge receipt of notice of the claim and confirm the dollar limits of coverages.

Reservation of rights under the Unfair Trade Practices Act

Assuming that the insured has provided timely notice of claim to the insurance company, it has initial duties under the claim settlement practices section of the Montana Insurance Code, MCA §33-18-201. First, it must conduct a "reasonable investigation based upon all available information," and second, it must "affirm or deny coverage of claims within a reasonable time." Some view these as competing demands that result in available coverage defenses and grounds for denial being left out of reservation of rights letters.¹² However, in Montana, the company is clearly required to notify the insured of its position. In *Portal Pipeline Co. v. Stonewall Ins. Co.*,¹³ the court said:

It is well established in Montana that an insurer has an obligation to inform the insured of all policy defenses it intends to rely upon. Section 33-18-201(14) MCA, of the Unfair Trade Practices Act provides that an insurer may not:

"[F]ail to promptly provide a reasonable explanation of the basis in the insurance policy in relation to the facts or applicable law for denial of a claim..."

However, the court also held that an excess carrier has no duty to make reservation of rights during the primary carrier's defense under its policy, if the excess carrier did not have the duty to defend or undertake defense.

Timeliness of the reservation of rights

Timeliness of the reservation of rights letter is governed by MCA §33-18-201(5), which says that the insurer may not "fail to affirm or deny coverage of claims within a reasonable time after proof of loss statements have been completed." Montana law tells us little about the limits of "a reasonable time."

The court estopped Safeco from asserting policy exclusions when it withdrew from defense after representing

its insured in a wrongful death action for 18 months without a reservation of rights.¹⁴ The court cited the Washington case of *Transamerica Ins. Group v. Chubb & Son, Inc.*, 554 P.2d 1080 (1976), which affirmed an estoppel where the insurer defended for ten months without a reservation of rights. However, the inner limit of time in which a carrier should reasonably issue the letter is not clear. Florida gives carriers 30 days from the time they knew or should have known of the defense to provide its insured the reservation of rights, or 60 days to refuse in writing to defend, enter a non-waive agreement, or obtain mutually agreeable independent counsel.¹⁵ Virginia requires that the insurer reserve its rights within 20 days of the insurer's discovery of the insured's breach of the insurance policy contract, if the carrier intends to rely on that breach to deny coverage.¹⁶ California requires the notified insurer to "accept or deny the claim in whole or in part, and affirm or deny liability" within 40 days. The fact that recommendations about timeliness use such terms as "prompt" and "immediately,"¹⁷ indicate a reasonable time would be measured in a matter of weeks.

The insurer's options after investigation

The primary carrier which has completed its initial investigation essentially has three options:

- 1 Defend the policyholder without reservation. If the claim falls in the policy language and the carrier has no policy defenses, it will undertake defense

The court held that, by reason of its conduct, Safeco was estopped to deny coverage, so that Ellinghouse was owed defense and indemnity.

- with the expectation that it will indemnify the insured for any loss. As will be seen, if it elects this option, it cannot raise policy defenses later.
- 2 Undertake defense under a reservation of rights. If the claim appears on its face to fall under the policy language but the carrier believes the facts will ultimately show it does not, it must issue a reservation of rights letter before undertaking defense to preserve its policy defenses and the option of refusing to indemnify for loss.
- 3 Disclaim any obligation to defend or indemnify based on policy defenses. If the claim does not fall within the policy language, the carrier can "disclaim" coverage and refuse defense or indemnity.

Defending the policyholder without reservation: the doctrines of waiver and estoppel

If the carrier defends without a reservation of rights, it will be estopped from later asserting any policy defense to avoid indemnification. It is said that the doctrines of waiver and estoppel cannot create coverage where it did not exist under the policy. However, the court

in the Texas case of *Paradigm Ins. Co. v. Texas Richmond Corp.*,¹⁸ noted that, where the insurer undertakes defense without a reservation of rights letter, coverage could be created under the doctrines of waiver and estoppel. Consequently, it is in the interest of the insured and the injured claimant for the insurer to undertake defense with-

out issuing an appropriate reservation of rights at the right time, because coverage may thereby come into existence like light upon

the darkness.

Estoppel requires proof of detrimental reliance on the part of the insured that forecloses an insurer from asserting policy defenses. Under estoppel principles, the carrier should only be precluded from asserting a coverage defense in the absence of a reservation of rights, if the insured can show prejudice (detrimental reliance) as a result of the insurer's conduct. However, in *Safeco Ins. Co. v. Ellinghouse*,¹⁹ the Montana Supreme Court adopted the general rule from Couch, *Insurance* 2d, 51.85 (2d ed. 1982):

Where an insurer, without reservation and with actual or presumed knowledge, assumes the exclusive control of the defense of claims against the insured, it cannot thereafter withdraw and deny liability under the policy on the ground of non-coverage, prejudice to the insured by virtue of the insurer's assumption of the defense being, in this situation, conclusively presumed... the loss of the right of the insured to control and manage the case is itself prejudicial.

Consequently, in Montana,

the prejudice will be presumed when the insurer has assumed exclusive control of the defense. In *Ellinghouse*, which is Montana's best example of a case of estoppel, Safeco's insured, Ellinghouse, was sued for wrongful death under a commercial general liability policy. Safeco accepted coverage of the claim without question or reservation of rights and retained an attorney who undertook defense of Ellinghouse for 18 months. Safeco's chief examiner later concluded that coverage was excluded by exclusions to the CGL policy. Accordingly, during the defense, Safeco's adjuster secured Ellinghouse's signature on a purported non-waiver agreement, and the company later withdrew from representation formally denying coverage 18 months after the claim was initiated. The court held that, by reason of its conduct, Safeco was estopped to deny coverage, so that Ellinghouse

was owed defense and indemnity. Safeco's conduct resulted in a \$5.3 million jury verdict later reduced by the Montana Supreme Court.²⁰

Waiver of defenses by failure to issue reservation of rights letter

The Montana Supreme Court defined waiver in *Osborne v. Supreme Lodge, Knights of Pythias v. Insurance Department*²¹ saying a "waiver" consists of the intentional relinquishment of a known right and cannot exist unless the party affected has knowledge of the subject matter or, by reason of the circumstances, knowledge is imputed to him. Though many courts speak of waiver where the insurer has undertaken defense without a reservation of rights, waiver probably does not apply. The carrier isn't really overtly relinquishing a known right nor would the carrier intentionally waive a coverage defense where the result would

create coverage it doesn't believe exists.²²

If the carrier believes it owes no coverage, it must defend under formal reservation of rights or file a declaratory judgment regarding its obligations to its insured. Recently, Safeco followed that procedure in *Safeco Ins. Co. of America v. Liss*.²³ Its insured, a woman named Liss, shot another woman, Bruthers, when she caught her riding in the cab of a road grader with her husband. Liss contended her shooting Bruthers was accidental, so Safeco issued a reservation of rights letter and provided Liss a defense until it could secure a declaratory judgment that it had no coverage. The District Court granted summary judgment in Safeco's favor. However, the Montana Supreme Court overturned it on the ground that there was a material issue of fact regarding the intentional or accidental nature of the shooting. Nevertheless, as the

Video Depositions, Re-enactments

Experienced Legal Video Specialist

Available statewide in Montana

1-888-995-8433

JOSH



Productions

(406) 523-6650
joels@montana.com
www.videomontana.com

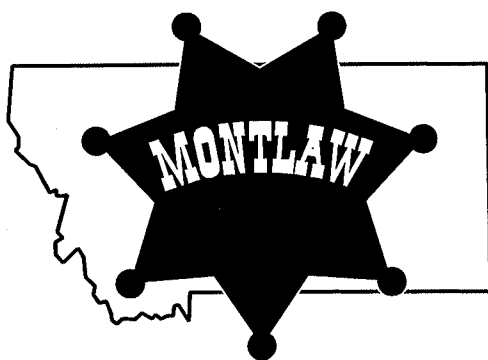
1001 E. Broadway #2
PMB 515
Missoula, MT 59802

court said in *City of Bozeman v. AIU Ins. Co.*,²⁴ "an insurer may step out of a suit once it clearly and unequivocally demonstrates that the plaintiff's claim against the insured no longer falls within the policy's coverage."

If the duty to pay the judgment may not be determined until the original action is completed, and the pleadings state a cause that fits within the policy coverage, then the carrier has a duty to defend. In *Northwestern Nat. Cas. Co. v. Phalen*,²⁵ the carrier undertook

defense under a reservation of rights letter and then secured summary judgment that it had no duty to defend the action by the victim of its insured's assault. The insured apparently took no action to secure defense by Northwestern, but the victim did, contending that Northwestern waived its rights by assuming defense of the action. The district court had granted the insurer summary judgment on the strength of the insured's plea of guilty to the criminal charge. The Supreme Court reversed holding that the plea of

guilty to the criminal charge does not conclusively preclude the policy coverage. Nor is the duty to defend affected by the insured's lack of interest in the tort action or the declaratory judgment action. Said the court, "The injured party's rights as a claimant vested at the time of the accident and could not be affected by nondefense of an action brought by the insurer to rescind the insurance policy."²⁶ The court found summary judgment to be improper because, in the court's view, applicability of coverage could



Just another day in
PARADISE

**All these databases:
 unlimited usage per firm
 for one low price!**

No downloading or printing charges!

*Nobody does **Montana law**
 better than **Montlaw**.*

Call for a free demo!
449-8889 or 800-816-0636

Federal Courts:

- U.S. Supreme Court (all states -1990+)
- 9th Circuit Court of Appeals (all states -1990+)
- 9th Circuit Court of Appeals, Bankruptcy Appellate Panel
- U. S. Bankruptcy Court - Montana (1989+)
- U. S. District Courts - Montana (1987+)

State Courts/Agencies:

- Montana Supreme Court (1868+)
- Montana State District Courts (1990+)
- Administrative Rules of Montana (10/99+)
- Montana Codes Annotated/Annotations (1989+)
- Attorney General (1957+)
- Montana Workers' Compensation Court (1986+)
- Montana Water Court (1991+)
- Human Rights Commission (1992+)
- Montana Office of Public Instruction (1992+)
- Public Service Commission (1985+)
- State Tax Appeal Board (1998+)
- Child Support Enforcement Division (1993+)
- Dept. of Labor & Industry - Unemployment Ins., Wage & Hour, Collective Bargaining (1999+)
- State Bar of Montana Ethics Committee (1993+)

Tribal Courts (Opinions and Codes):

- Fort Peck Tribal Court (1986+)
- Limited text from Blackfeet, Crow, Confederated Salish and Kootenai Tribal and Northern Cheyenne Courts



**STATE REPORTER
 PUBLISHING COMPANY**

P. O. Box 749
 Helena, Montana 59624

not be determined until the underlying tort action was completed.

Disclaiming any duty to defend or indemnify

If the carrier's position is strong enough, it may deny coverage entirely and refuse to defend leaving the insured with the decision whether it is viable to file any action to enforce rights against the carrier. The court made clear in *City of Bozeman v. AIU Ins. Co.*, "Ordinarily, a liability insurer has no duty to defend an action against its insured when the claim or complaint clearly falls outside the scope of the policy's coverage."²⁷ And, in *Insured Titles, Inc. v. McDonald*,²⁸ the court said, "If the asserted claim is not covered by the policy, then the insurer has no duty to defend the insured." In *Burns v. Underwriters Adjusting Co.*,²⁹ the insured, Burns, presented the carrier with a lawsuit for injury caused by his battering of the plaintiff, Zeiler. In response, Underwriters issued Burns a reservation of rights letter (a "disclaimer") denying coverage for the intentional act. After Burns plead guilty to felony aggravated assault, Underwriters issued additional reservation of rights letters (disclaimers) denying coverage and refused to take up any defense. The Montana Supreme Court held there was no duty to defend.³⁰

If the company determines that there is no coverage and elects not to defend or indemnify, it must send a letter of disclaimer and state its defenses with specificity just as in the reservation of rights.³¹ In such cases, it is a well-settled rule that failure to assert a ground in the disclaimer waives that ground.³²

Once the carrier determines that the existence of coverage is questionable, it should, because of its fiduciary relationship with its insured, refrain from conducting further investigation by getting information directly from its insured. An Indiana Court of Appeals, in *Snodgrass v. Baize*,³³ differentiated between statements taken from the insured in initial investigation and those obtained after the coverage conflict is discovered and disclosed to the insured, holding that the former could be used to deny coverage while the latter would be subject to estoppel.

The company must communicate the reservation of rights to the insured and fairly inform the insured of the carrier's position.³⁴ The insurer must act "openly and with the utmost loyalty to its insured...in initially explaining the insurer's position... and must make specific reference to the policy defense which may ultimately be asserted."³⁵ The company must set forth for the insured every reason of which it is aware that constitutes a basis for denying or limiting coverage and must do so with specificity. General statements that the carrier intends to reserve all rights it

has under its policy are inadequate. Supplementation of the reservation of rights letter to state additional bases for refusing coverage must not be prejudicial to the insured.³⁶ Subsection 14 of Montana's Unfair Claim Settlement Practices Act³⁷ requires that the insurer "promptly provide a reasonable explanation of the basis in the insurance policy in relation to the facts or applicable law for denial of a claim or for the offer of a compromise settlement."

The duty to defend

When the company sends a reservation of rights letter, it has an immediate duty to defend, even if the claim is a "mixed action" in which some claims are covered and others are not. In the California Supreme Court case of *Aerojet-General Corp. v. Transport Indem. Co.*,³⁸ the court said, "The insurer has a prophylactic duty to defend the entire mixed claim. That is because to defend meaningfully, it must defend immediately, and to defend immediately, it must defend entirely." Miller describes as "insane" the practice of many insurers of issuing reservation of rights letters and then embarking on a months-long investigation without undertaking the defense. He says, "Nowhere in the insurance policy does it say that the insurance company can ponder its navel for months before

"AMFS Only the Best Medical Experts..."

Speak to one of our staff physicians with
just one phone call—at no charge to you.

AMFS staff physicians collaborate to
personally review your medical records,
formulate opinions, and
match experts to your
cases from our carefully
pre-screened panel of
board-certified specialists
in your region.

AMFS bridges medicine and law...
more than 4,000 specialists in more
than 20,000 cases since 1990.

AMFS
American Medical Forensic Specialists, Inc.

A physician managed company

1-800-275-8903

www.amfs.com
medicalexperts@amfs.com

AMFS CLIENT
Michael E. Cardoza
SAN FRANCISCO TRIAL ATTORNEY

committing to either defending the insured or declining coverage. The duty to defend is a contractual duty and it must be honored upon the tender of the complaint to the insurance company." Miller contends that, if the insurer took six months to decide not to defend, then they owe the insured six months of defense costs for the period the insured had to defend himself. Consistently, if the insurer, under reservation of rights, defends claims not even potentially covered, then it can recover those defense costs.³⁹ If the underlying claims are based on theories of recovery that are broader than the exclusion on which the insurer seeks to deny coverage, then the insurer must defend and can simply reserve the right not to indemnify on the excluded claims or share duties with independent co-counsel.⁴⁰

The conflict created by the reservation of rights letter

Generally, defense of most claims under casualty policies does not involve a conflict between the insured and the insurer. Competent insurance defense counsel advise their insurers that counsel owe their primary duty to the insureds and give little weight to the interests of the insurer in litigation. In Montana, insurers' attempts to control defense and costs of defense have been held to be the unauthorized practice of law.⁴¹ Counsel generally zealously defends the

insured, does not consider the interests of the insurer, and takes no actions adverse to the interests of the insured.⁴² However, when a situation develops in which a conflict may exist between the interests of the insured and the insurer, defense counsel may recommend that the insurer obtain separate counsel to represent the company's interest, or in the case of many coverage disputes, recommend the insurer issue a reservation of rights letter and inform the insured that the insured may wish to seek the advice of independent counsel. When an insurer receives a claim, one of its first duties is to determine whether there is any such conflict of interest between it and its insured. If there is, the insurer must deal with the conflict and may ultimately have to hire independent counsel for its insured.

In a coverage dispute, where the insurer issues its reservation of rights and then proceeds to defend, there is an automatic conflict between the interests of insured and insurer. Obviously, where the carrier's position is that some or all of the claims are not covered, thereby giving notice that it does not intend to indemnify, the conflict is clear. In *In Re Rule of Professional Conduct*,⁴³ The Montana Supreme Court recognized that a potential conflict of interest exists where the insurer provides defense subject to a reservation of rights. Absent a negotiated agreement between the insured and insurer as to how to proceed, the insurer must elect an option, and the insured's personal counsel must make demand on the carrier for the option which will best protect the insured.

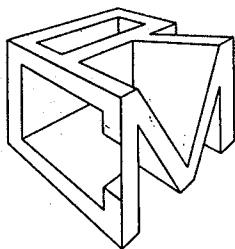
Resolution of the reservation of rights conflict

Courts have used different approaches to the duty owed the insured by the insurer where the insurer believes that a claim for which the insured demands indemnity and defense does not fall within the policy coverage. Unless the claim on its face is clearly outside the coverage, the insurer questioning coverage but exercising prudence will provide the insured with a reservation of rights and proceed with the defense. There is variation in the duty courts place on the insurer, however.⁴⁴ Some allow an insurer to refuse defense and still preserve the right to later litigate the coverage issue after the insured has conducted the defense.⁴⁵ This leaves the insured bearing the costs of defense unless a court should ultimately decide later that the insurer was responsible. Other courts decide that, in the face of a coverage conflict, the insurer must defend, but that neither insured nor insurer are foreclosed from subsequently litigating the coverage issue.⁴⁶ This leaves the insurer bearing the costs of defense with little hope of recouping the costs if the court ultimately decides that there was no coverage.

ORTHOPEDIC BIOMECHANICS

- ° ACCIDENT RECONSTRUCTION
- ° MECHANISMS OF INJURY
- ° BIOMECHANICS
- ° MECHANICAL LAB SERVICES
- ° MULTIPLE PUBLICATIONS IN FIELD

UNIVERSITY ORTHOPEDIC AND BIOENGINEERING FACULTY EXPERIENCE



CRM, Inc.

1540 Lake Elmo Dr.
Suite No. 5
Billings, MT 59105
(406) 245-5704

The problem is that the insurer which undertakes the defense in the face of a coverage dispute is ethically bound not to act in its interest to the detriment of the insured by developing through fact investigation or discovery the facts necessary to prove lack of coverage.⁴⁷ Consequently, a third line of decisions represented by the landmark "*Cumis*" case⁴⁸ would forbid the insurer in the coverage dispute from undertaking the defense of the insured but would require that the insurer pay the costs of defense and provide the insured an independent counsel.⁴⁹ In California this procedure is statutory.⁵⁰

Interestingly, the Montana Supreme Court, in the 1967 case of *St. Paul Fire and Marine Ins. Co. v. Thompson*,⁵¹ appears to have concluded that State Farm had to pay attorney fees for independent counsel for its insured. In that case, an employer (insured by St. Paul) and its employee, Thompson, (insured by State Farm) were sued for joint liability for bodily injury arising out of an auto accident in which Thompson drove his own car while working. State Farm paid out its limits in a joint settlement, after which St. Paul sued Thompson on the employer's subrogated claim for contribution. Thompson demanded defense from State Farm which refused, citing the fact that it had paid out its limit for indemnity. The court held that the duty to defend was independent of the duty to indemnify and that State Farm owed the duty to defend. The court then went on to say:

But, State Farm argues that it should be allowed to defend rather than paying counsel to defend the action. There can be no question of the good faith and sincere defense by counsel for State Farm in the Welch suit nor here. However, the inconsistent and yes, antagonistic positions that have developed make it clear that Thompson was required to hire his own counsel. No issue as to the amount of damages is involved.

Though the exact dispute the court was discussing is unclear, it appears that the court was ordering State Farm to pay \$2,500 attorney fees for its insured's independent counsel in a situation where State Farm thought its attorneys should be allowed to defend, but the court found the insurer's position inconsistent and antagonistic to that of its insured. The Montana court's approach appears to be consistent with *Cumis* which was not decided until 1984.

There is no conflict if the insurer elects to defend unconditionally (without reservation of rights) since estoppel will later prevent the insurer from withdrawing defense.⁵² However, if the insurer defends under reservation of rights, there is potential conflict,

Forensic Chiropractic Examination

- ✓ Personal review of medical-chiropractic records.
- ✓ Independent chiropractic examinations.
- ✓ Professional opinions rendered.
- ✓ Consultation regarding records and forensic IME examinations.

Dr. Thomas C. Donahue

Chiropractic Doctor, Master of Science - Rehabilitation Counseling (MSU), Certified Chiropractic Sports Physician (ACA Sports Council), Certified Disability Evaluator Category 1 (NADEP), Certified Independent Chiropractic Examiner (ABIME), Certified Independent Forensic Chiropractic Medical Examiner (NBOFC), Certified Disability Impairment Rater (NAAIRP), and Diplomate American Board of Forensic Professionals (ABFP).

For more information, a copy of Dr. Donahue's CV, or questions about consultation, please call or e-mail:

1-888-256-9569

chirosport@montana.com

**Dr. Thomas C. Donahue
2520 17th St. W. Suite 101
Billings, MT 59012**

since the carrier may only be concerned about the interim costs of defending while the insured must worry about the ultimate cost and payment of loss.

Windt asserts that issuance of a reservation of rights does not necessarily mean that a conflict exists such that the carrier will lose the right to select counsel. He states that a conflict exists only if a coverage issue will later be determined by facts in the lawsuit being defended and the outcome can be controlled by defense counsel. But, he notes that a conflict can arise with regard to the conduct of the insured's defense:⁵³

Specifically, a conflict over the existence of coverage will serve to create a conflict of interest with regard to the insured's defense when the insurer's potential liability could be reduced if the insured were defended in a particular manner.

As an example, he cites the situation where plaintiff has plead alternate theories of negligence and intentional conduct and it would be in the insurer's interest and against the insured's interest to develop facts showing that the conduct was intentional.⁵⁴ Such a conflict would require that the insured select independent counsel.⁵⁵

Conclusion

The stakes can be high and the risk great when the insurance company and its insured who is being sued disagree on whether there is coverage for defense or indemnity. Issues of coverage are of grave concern to plaintiff's counsel who must secure adequate compensation for the injured claimant even if that means settling for an assignment of the policyholder's bad faith rights against the insurer for failing to defend or indemnify. A specific body of law and standard of care has

developed around the reservation of rights letters and the duty to defend. It is imperative that counsel for the policyholder and for the injured plaintiff be vigilant in observing the carrier's conduct in disclaiming coverage, reserving rights to deny coverage, and defending under reservation of rights to insure that standards are met. Counsel must be attentive to the possibility that the insurer can be estopped from asserting an otherwise valid policy defense or can be held to have waived an exclusion or other defense. Counsel may literally be able to create coverage where none existed if the carrier is careless.

(Thanks to Pat Sheehy and Gary Zadick for their review and comment on this article and law student, Kevin Sheahan, for cite checking and footnote formatting.)

1. *Irion v. Glens Falls Ins. Co.*, 154 Mont. 156, 461 P.2d 199 (1969).
2. Id.
3. Id.
4. 419 P.2d 168 (1966).
5. 202 Mont. 1, 655 P.2d 970 (1982).
6. *Thomas v. Northwestern Natl. Ins. Co.*, 973 P.2d 804 (Mont. 1998).
7. *Aetna Life & Cas. Co. v. McCabe*, 556 F.Supp. 1342 (E.D. Pa. 1983).
8. Eugene R. Anderson, Jordan S. Stanzler & Lorelie S. Masters, INSURANCE COVERAGE LITIGATION, § 3.06 [A].
9. Clinton E. Miller, HOW INSURANCE COMPANIES SETTLE CASES, §363 (2000).
10. Miller notes that it is unwise for the insurer to assert technical defenses such as failure to cooperate or supply information (i.e., medical documents where insurer already has release) to avoid valid claims.
11. Robert N. Kelly, *The Opening Act—Notice, Investigation, and Reservation of Rights*, LITIGATING THE COVERAGE CLAIM, ABA Tort and Ins. Pract. Section, 1 (1992).
12. M. Taylor Florence & Kevin S. Mapes, *Failure to Specify all Grounds for Disclaimer of Coverage*, David E. Leitner, RECURRING ISSUES IN INSURANCE DISPUTES, ABA Tort and Ins. Pract. Section 1996.
13. 256 Mont. 211, 845 P.2d 746 (1993).
14. *Safeco Ins. Co. v. Ellinghouse*, 223 Mont. 239, 725 P.2d 217 (1986).
15. Fla. Stat. ch. §627.426 (2) (2000).
16. Va. Code Ann. § 38.2-2226 (1990).
17. Miller, § 363.
18. 942 S.W.2d 645 (Tex. Ct. App. 1997).
19. 223, Mont. 239, 725 P.2d 217 (1986).
20. Id.
21. 69 Mont. 361, 222 P.2d 456 (1924).
22. Robert N. Kelly, *The Opening Act—Notice, Investigation, and Reservation of Rights*, LITIGATING THE COVERAGE CLAIM, ABA Tort and Ins. Pract. Section, 1 (1992).
23. 2000 MT 380, 16 P.3d 399.
24. 262 Mont. 370, 865 P.2d 268 (1993).
25. 182 Mont. 448, 597 P.2d 720 (1979).
26. *Citing McLane v. Farmers Ins. Exchange*, 150 Mont. 116, 432 P.2d 98 (1967).
27. 262 Mont. 370, 865 P.2d 268 (1993).
28. 275 Mont. 111, 911 P.2d 209 (1996).
29. 234 Mont. 508, 765 P.2d 712 (1988).
30. For law on avoiding the intentional acts exclusion, see this column in Montana Trial Trends, Winter 2000.
31. Anderson, Stanzler & Lorelie, above, at §3.06[B].
32. Id.
33. 405 N.E.2d 48 (Ind. Ct. App. 1980).
34. *Cowan v. Ins. Co. of North America*, 318 N.E.2d 315 (Ill. App. 1974).
35. Id.
36. *Bensalem Township v. Western World Ins. Co.*, 609 F. Supp. 1343 (E.D. Pa. 1985).
37. Mont. Code Ann. § 33-18-201 (14).
38. 948 P.2d 909 (Cal. 1997).
39. Miller, above, at §363.
40. *GRE Ins. Group v. Metropolitan Boston Housing Partnership*, 61 F.3d 79 (1st Cir. 1995).
41. *In the Matter of the Rules of Professional Conduct*, 2000 MT 110, 2 P.3d 806.
42. 1 Allen D. Windt, INSURANCE CLAIMS AND DISPUTES § 4.19, AT 217 (3d ed. 1995).
43. 2000 MT 210, 2 P.3d 806, 813.
44. Allan D. Windt, INSURANCE CLAIMS AND DISPUTES, Sec. 4.22, pg. 226 (3d Ed. 1995). Windt says there are six lines of authority "as to what the insurer can or must do when it has a duty to defendant there is a conflict of interest between it and the insured regarding the conduct of the insured's defense.
45. See, for example *Burd v. Sussex Mutual Ins. Co.*, 56 N.J. 383, 267 A.2d 7 (N.J. 1970).
46. See, for example, *Gray v. Zurich Ins. Co.*, 419 P.2d 168 (Cal. 1966).
47. *Parsons v. Continental Natl. Am. Group*, 550 P.2d 94 (Ariz. 1976).
48. *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y Inc.*, 208 Cal. Rptr. 494 (Ct. App. 1984).
49. See, Windt, *supra* §4.22.
50. Cal. Civ. Code § 2860 (West 1999).
51. 433 P.2d 795.
52. Windt, 4.20.
53. Windt, Sec. 4.20, pg. 221-222.
54. Id., at 222.
55. See, e.g. *Parsons v. Cont'l Natl. Am. Ins. Co.*, 550 P.2d 94 (Ariz. 1976). ■